



FIRST REPORT
OF THE JOINT LEGISLATIVE
AUDIT COMMITTEE

December 31, 1958

STATE OF CALIFORNIA

FIRST REPORT
OF THE JOINT LEGISLATIVE
AUDIT COMMITTEE

December 31, 1958



MEMBERS OF THE COMMITTEE

ASSEMBLYMEN

CASPAR W. WEINBERGER, *Chairman*
GLENN E. COOLIDGE
JESSE M. UNRUH

SENATORS

ARTHUR H. BREED, JR., *Vice Chairman*
HUGH P. DONNELLY
J. HOWARD WILLIAMS

WILLIAM H. MERRIFIELD, *Secretary*
Auditor General

Room 430, State Capitol
Sacramento, California

CHAIRMAN
CASPAR W. WEINBERGER
TWENTY-FIRST DISTRICT

SECRETARY AND AUDITOR GENERAL
WILLIAM H. MERRIFIELD

VICE CHAIRMAN
ARTHUR H. BREED, JR.
SIXTEENTH DISTRICT

ASSEMBLYMEN
GLENN E. COOLIDGE
TWENTY-SEVENTH DISTRICT
JESSE M. UNRUH
SIXTY-FIFTH DISTRICT

GOVERNMENT CODE, SECTIONS 10500-10504

SENATORS
HUGH P. DONNELLY
TWENTY-SECOND DISTRICT
J. HOWARD WILLIAMS
THIRTY-SECOND DISTRICT

Joint Legislative Audit Committee

GOVERNMENT CODE, SECTIONS 10500-10504

California Legislature

ROOM 430, STATE CAPITOL
SACRAMENTO, CALIFORNIA

LETTER OF TRANSMITTAL

December 31, 1958

The Honorable President Pro Tem of the Senate

The Honorable Speaker of the Assembly

*The Honorable Members of the Senate and
Assembly of the Legislature of California*

State Capitol, Sacramento, California

SIRS:

We transmit herewith our first report covering all of the activities of your Joint Audit Committee from its formation in 1955 to date. The Committee believes that the new post audit procedure is now well established and that the Auditor General and his office are performing a most valuable function in aid of the basic duty of the Legislature to oversee the operation of the Executive Branch.

The work performed by the very able Auditor General and his experienced staff has already brought about a great many improvements in administration and in the safeguarding of State funds.

In the years ahead the work of this Committee and of the Auditor General's office can be of critical importance in assuring the people of California that their State government is being run with the highest degree of honesty and efficiency.

Respectfully submitted,

Assemblymen
GLENN E. COOLIDGE

Senators
HUGH P. DONNELLY

JESSE M. UNRUH

J. HOWARD WILLIAMS

*CASPAR W. WEINBERGER,
Chairman*

*ARTHUR H. BREED, JR.,
Vice Chairman*

TABLE OF CONTENTS

	Page
History of Legislative Auditing Service.....	7
Creation of Joint Legislative Audit Committee and Office of the Auditor General	8
Provisions of the Act.....	9
Legislative Purpose	9
Joint Legislative Audit Committee.....	9
Auditor General	10
Activities of Joint Legislative Audit Committee.....	11
Membership of Committee.....	11
Meetings of Committee.....	11
Adoption of Rules.....	12
Audit Policy	12
Selection of Auditor General.....	13
Selection of Deputy Auditor General.....	14
Office Space	15
Recruitment of Audit Staff.....	15
Legislative Audit Advisory Board.....	16
Activities of the Office of the Auditor General.....	18
Study of Claim Processing Procedures.....	18
Review of System of Internal Control.....	20
Audits of State Agencies.....	23
Coordination of Audit Activities.....	30
Future Program	32
Expenditures	34
Appendix A—Comments on Scope of Auditing for Joint Legislative Audit Committee	35
Appendix B—Roster of Employees	41
Appendix C—Summary of Direct Time in Hours Reported on Assignments, Classified by Functions of State Government, to December 31, 1958.....	42
Appendix D—Reports Prepared to December 31, 1958.....	43
Appendix E—Reports in Process at December 31, 1958.....	46
Appendix F—Audit Assignments in Process at December 31, 1958.....	48
Appendix G—Defalcations in State Agencies.....	49

HISTORY OF LEGISLATIVE AUDITING SERVICE

By the year 1950, 12 states had established an independent audit function in the legislative branch of the government or had transferred the auditing responsibilities from the executive to the legislative branch. Since 1950 eight additional states, including California, and two territories have taken similar action. Generally this development is attributed to a drive to centralize operating responsibilities under the Governor as the general manager, and to provide independent auditing and reporting directly to the Legislature as the board of directors. This independent audit compares with that performed by independent firms of public accountants for boards of directors in private industry. There is strong evidence that other states will be following the example of the 20 states and two territories which have established independent legislative auditing services.

This movement, which has been gaining impetus throughout the Nation, is a clear indication of the growing recognition of the right and the duty of state legislatures to inform themselves concerning:

- The efficiency of the conduct of activities by the executive branches of state governments,
- The adequacy of the machinery for collection of revenues,
- The integrity of the system of utilizing and safeguarding assets, and
- The propriety of the expenditure of funds appropriated by the legislatures.

There obviously is an increasing awareness in the state legislatures of the need of establishing facilities for supplying to them such information, obtained and reported factually and without bias by qualified auditors who are directly responsible to the legislatures.

The Federal Government recognized the importance of the Congress informing itself as to the activities of the Executive Branch by independent means when it established the General Accounting Office in 1921, part of the duties of this office being to audit and report directly to the Congress on the financial functioning of the various agencies. The Division of Audits of the General Accounting Office was established in 1952, and brought together several divisions which had been formed in earlier years to perform specific auditing tasks.

As early as 1936 the Legislature of the State of California began consideration of the advisability of creating the means whereby it could be informed independently as to whether the Executive Branch of the State Government was carrying out the intent of enacted legislation relating to expenditures and taxation. In that year the California Conference on Government and Taxation-Interim Committee of Twenty-five was organized and retained a consulting firm to conduct a study of the existing governmental structure. Included in the consulting firm's recommendations was the creation of an office whereby independent audits would be made of the activities of the Executive Branch of the State Government by an auditor appointed by and responsible to the Legislature.

As a result of this and other studies, bills to establish such an office were presented to each regular session of the Legislature from 1937 through 1953, but all of them either failed of enactment or were not approved by the Governor.

CREATION OF JOINT LEGISLATIVE AUDIT COMMITTEE AND OFFICE OF THE AUDITOR GENERAL

The 1955 Session of the State Legislature established the Joint Legislative Audit Committee and the Office of the Auditor General by the enactment into law of Senate Bill No. 1540, of which Senators Hugh P. Donnelly and Luther E. Gibson were the authors, as Chapter 1699, Statutes of 1955. This act added Chapter 4 to Part 2, Division 2, Title 2, of the California Government Code.

PROVISIONS OF THE ACT

Legislative Purpose

The act states that the Legislature recognizes the needs of the Executive Branch of the State Government for its own periodic and special audits of the revenues and expenditures of the state agencies and their accounting and reporting systems as a means of insuring the proper and lawful expenditures of state funds. The Legislature states its desire that these needs be filled by *internal* auditing co-ordinated in the Executive Branch of the government in the interest of economy and efficiency.

The Legislature also recognizes the necessity of an *independent* audit for the use of both the executive and legislative branches of the government in establishing sound fiscal and administrative policy for the government of the State. The Legislature has placed the responsibility for this independent audit in the Office of the Auditor General which it created and placed under the direction of the Joint Legislative Audit Committee.

The provisions of the act were prepared generally in conformity with the recommendations of the report of Price Waterhouse & Co. on its survey of accounting and auditing for the State of California made in 1954 for the Joint Legislative Budget Committee. The Price Waterhouse & Co. recommendations were in agreement with the recommendations of the Senate Interim Committee on Government Organization as shown in that committee's reports to the Legislature in 1953 and 1955.

Joint Legislative Audit Committee

The Joint Legislative Audit Committee consists of three members of the Senate and three members of the Assembly. The act provides that the members of the committee shall be selected and vacancies occurring in the membership shall be filled in the manner provided for in the Joint Rules of the Senate and Assembly. The Joint Rules currently provide that the Senate members shall be appointed by the Senate Committee on Rules and that Assembly members shall be appointed by the Speaker of the Assembly. The act also provides that the Joint Legislative Audit Committee have continuing existence and that it may meet, act, and conduct its business at any place within the State, during the sessions of the Legislature or any recess thereof, and in the interim period between sessions.

The duties and responsibilities of the committee are to appoint an Auditor General and a deputy, to determine the policies of the Auditor General, ascertain facts, review reports and take action thereon, and make recommendations to the Legislature concerning the state audit, the revenues and expenditures of the State, its departments, subdivisions, and agencies. The committee is authorized to make rules governing its own proceedings and to create subcommittees from its membership and assign to such subcommittees any study, inquiry, investigation, or hearing which the committee itself has authority to undertake or hold. The committee has the powers and authority granted to investigating committees by Joint Rule 36 of the Senate and Assembly. Joint Rule

36 provides, generally, that a committee may fix rules governing its procedure, may employ such assistants as may be necessary, and shall be empowered to subpoena witnesses and records. Under this rule every department and agency of the State Government and of every political subdivision of or in the State is required to furnish a committee such information or records as the committee deems necessary for the achievement of the purposes for which it was created.

Auditor General

The act sets forth the minimum qualifications for the Auditor General, which are as follows:

- (a) The possession of a valid certificate issued by the State Board of Accountancy to practice as a certified public accountant or a public accountant.
- (b) Seven years of experience in governmental accounting in an executive position involving responsibility for directing the work of an auditing staff of not less than 20 accountants.
- (c) Or he shall have any combination of experience which in the opinion of the committee is the equivalent of (b).

The permanent office of the Auditor General is designated as Sacramento and provisions are made for the establishment of offices in other places when in his judgment they are required for the conduct of the work.

The Auditor General during regular business hours has access to, and authority to examine, any and all books, accounts, and other records and property of any agency of the State whether created by the Constitution or otherwise.

It is the duty of the Auditor General to examine and report annually upon the financial statements prepared by the Executive Branch of the State to inform the Legislature as to the adequacy of such financial statements in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding fiscal year. The Auditor General is authorized to make such examinations of the accounts and records, accounting procedures and internal auditing performance as in his judgment are necessary to disclose all material facts for the use of the legislative and executive branches in establishing a sound fiscal and administrative policy for the government of the State.

It is also the duty of the Auditor General to make such special audits and investigations of any state agency as requested by the Legislature or any committee of the Legislature.

ACTIVITIES OF THE JOINT LEGISLATIVE AUDIT COMMITTEE

Membership of Committee

The following Senators and Assemblymen were appointed to the first Joint Legislative Audit Committee:

<i>Assemblymen</i>	<i>Senators</i>
Frank G. Bonelli	Arthur H. Breed, Jr.
Fifty-second District	Sixteenth District
Thomas W. Caldecott	Hugh P. Donnelly
Eighteenth District	Twenty-second District
Caspar W. Weinberger	J. Howard Williams
Twenty-first District	Thirty-second District

Assemblyman Glenn E. Coolidge of the Twenty-seventh District was appointed to the committee on September 30, 1957, to fill the vacancy caused by the resignation of Assemblyman Caldecott who accepted an appointment as a superior court judge of Alameda County.

Assemblyman Jesse M. Unruh of the Sixty-fifth District was appointed to the committee on July 24, 1958, to fill the vacancy caused by the resignation of Assemblyman Bonelli who was elected to the office of Supervisor of Los Angeles County.

Assemblyman Caldecott was elected chairman of the committee at its first meeting on October 7, 1955. He served in that capacity until his resignation in 1957. He was succeeded by Assemblyman Weinberger who was elected chairman at the October 29, 1957 meeting of the committee and served as chairman until the expiration of his term as Assemblyman January 5, 1959. Senator Breed has served as vice chairman of the committee since its first meeting.

Meetings of Committee

The committee has held 22 meetings since its inception. These meetings were held on the following dates:

October 7, 1955	June 11, 1957
October 24, 1955	October 29, 1957
December 7, 1955	December 12, 1957
December 20, 1955	February 4, 1958
January 20, 1956	March 4, 1958
February 15, 1956	March 11, 1958
March 22, 1956	March 18, 1958
May 17, 1956	August 29, 1958
October 26, 1956	September 22, 1958
February 14, 1957	October 24, 1958
February 28, 1957	December 5, 1958

Adoption of Rules

At its first meeting on October 7, 1955, the following rules were adopted by the committee:

1. The officers of this committee are a chairman and a vice chairman, and the committee shall appoint an Auditor General who shall act as secretary.
2. Four members of the committee shall constitute a quorum; provided, however, that such number shall include no less than two members from the Senate and two members from the Assembly.
3. Any action of the committee shall require an affirmative vote of not less than two of the Senate members and two of the Assembly members of the committee.
4. The chairman of the committee is authorized to appoint subcommittees to specify their duties, and to designate the membership of the subcommittees.
5. The chairman is authorized to fix the time and place of each meeting of the committee and shall give each member reasonable notice of each meeting.
6. The chairman shall preside at meetings when present, and in his absence the vice chairman shall preside. The vice chairman of this committee shall act as chairman in the case of a vacancy in the office of the chairman, or whenever such authority is delegated by the chairman.
7. The secretary shall keep a complete record of the meetings of the committee and of action taken by it.
8. The committee shall reorganize and elect new officers prior to the adjournment of each general session of the Legislature. The officers of the committee shall hold office until their successors are elected and have qualified.
9. The Legislative Counsel shall be the counsel for the Joint Legislative Audit Committee.

To facilitate the organization of the Office of the Auditor General, the Joint Legislative Audit Committee in a meeting held on May 17, 1956, authorized and directed the chairman to "do all things and take all actions which are necessary to furnish the committee with a staff, office space, supplies, facilities and equipment needed to carry out its responsibilities." This authorization specifically included, but was not limited to, authority to enter into employment contracts and other contracts in the name of, and on behalf of, the Joint Legislative Audit Committee.

Audit Policy

A statement on audit policy prepared for the committee by the Legislative Analyst was adopted on October 24, 1955, as the audit policy for the Office of the Auditor General. This policy statement is shown as Appendix A to this report. In adopting this audit policy, the committee made particular reference to the portion of the statement quoted below which was taken from the report of Price Waterhouse & Co. mentioned above:

"As to the duties and functions of the office: the auditor should have the primary duty, and necessary authority, to examine and report annually upon the financial statements of the State; such statements should be required to

be furnished to him by the Director of Finance, the State Controller and State Treasurer or other principal accounting officials. This should not require the annual examination of the statements and accounts of each department or agency; the scope of the work and the selection of the agencies should be left to the discretion of the auditor and his counseling committee. He should make such other examinations or investigations as he believes desirable and those he is directed to perform by the committee only, or the Legislature acting through it. * * *

"The auditor's authority, beyond that of examining, should be confined to reporting objectively and independently. The reports should include such comments, recommendations and suggestions as the auditor wishes to make but he should have no power to enforce them nor should he otherwise influence or direct executive or legislative actions. * * *

"The objectives of these examinations are given in the definition of the term 'auditing' which was set forth earlier in this section; restated briefly they are to ascertain:

"That the executive branch is carrying out only the activities and programs authorized by the Legislature and is doing so effectively and efficiently.

"That expenditures are made and revenues are collected in accordance with the laws and regulations.

"That the assets of the State are safeguarded and utilized properly.

"That the reports and financial statements prepared by the executive branch disclose all material information necessary to a proper evaluation of the State's activities."

Selection of Auditor General

Wide publicity was given to the selection of the Auditor General. A news release covering the following points was prepared:

Salary

Responsibilities of the job

Deadline for receiving applications

Qualifications as specified in the law and others desirable

The fact that the job, while noncivil service, is nonpartisan and technical in nature

The fact that reasonable continuity in office may be expected as evidenced by the experience of other comparable noncivil service positions responsible to the Legislature, such as Legislative Counsel and Legislative Analyst

Vacation, sick leave, and retirement provisions under California law

This news release was sent to the *California Certified Public Accountant* and such national publications as *The Journal of Accountancy*, *The Controller*, and *Municipal Finance*. The assistance of the American Institute of Certified Public Accountants was requested and it sent the news release to presidents, executive secretaries, and

editors of state societies of certified public accountants, to chairmen of committees on governmental accounting of state societies of certified public accountants and the local chapters of those societies.

Twenty-eight applications for the position of Auditor General were received from applicants in 12 states. Twenty-three of the applications received were from certified public accountants, three were from public accountants, and two applicants did not indicate whether they were certified public accountants or public accountants. Five applicants were selected for oral interviews. Two of these applicants were from California and one each from Kansas, Illinois, and Wisconsin. All the applicants interviewed were certified public accountants and had the basic qualifications set forth in the act. Interviews were conducted in San Francisco on December 20, 1955, and in Sacramento on January 20, 1956, and the Legislative Analyst made inquiry from references and other sources as to the credit, health and related personal characteristics of the candidates. On February 15, 1956, after a review of the information provided by the reports of the Legislative Analyst, the committee voted unanimously to select William H. Merrifield for the position of Auditor General.

In making its selection, the committee gave careful consideration to both professional and experience qualifications of the applicant, including his status as a certified public accountant, his academic record, the extensiveness of his public accounting experience, ability to evaluate the end product of governmental accounting systems, experience in supervising a professional staff, contact with large scale accounting operations, and his demonstrated ability to secure recognition for the position in his relations with the Legislature, the administration, the accounting profession, and the general public.

At the time of his selection, Mr. Merrifield was associated in Chicago, Illinois, with Peat, Marwick, Mitchell & Co., a nationally prominent firm of certified public accountants for whom he managed all governmental and institutional audits. Previous to its merging with the firm of Peat, Marwick, Mitchell & Co., Mr. Merrifield was a partner of the firm of George Rossetter & Co., Certified Public Accountants of Chicago, Illinois, managing the systems and procedures department of that firm and supervising all governmental audits. He had previously served in the capacity of secretary and director of a Chicago corporation, in full charge of accounting, and earlier was affiliated with Price Waterhouse & Co. He served in the important capacity of Chairman of the Committee on Governmental Accounting of the Illinois Society of Certified Public Accountants which has received recognition for the work which it has done toward improving municipal accounting in Illinois.

Mr. Merrifield was sworn in as Auditor General of the State of California on May 17, 1956.

Selection of Deputy Auditor General

The selection of the deputy auditor general was influenced by the viewpoint of the committee that he should not be a full-time administrative assistant as is the pattern in state departments, but that he should take an active part in the supervision of the technical phases of the program. On this basis John W. Shoemaker was selected as Deputy Auditor General and assumed his position on June 18, 1956.

Mr. Shoemaker is a certified public accountant with 20 years' experience in public accounting with outstanding firms of certified public accountants. The major part of his experience has been in audit supervision, including audits of governmental bodies, but he also has had important experience in report editing and staff recruiting. In 1941 Mr. Shoemaker received a national award from the American Institute of Certified Public Accountants for having achieved the highest grades in the uniform examination for the certificate of certified public accountant, which is given simultaneously in all of the states in May and November of each year.

The positions of Auditor General and Deputy Auditor General are considered as full-time positions which, because of the high degree of independence required, exclude part-time outside practice of accounting for remuneration.

Office Space

The State Capitol Committee allocated approximately 5,400 square feet of floor space in the north wing of the fourth floor of the State Capitol for the use of the committee. The nine offices which occupied this space were used as Assembly committee rooms and offices before the east wing was added to the State Capitol. This space has been altered by the Division of Architecture under the direction of the Assembly Rules Committee to provide an office with 18 modern, well-lighted, air-conditioned rooms. This space is now designated as Room 430, State Capitol, and is identified as the Offices of the Joint Legislative Audit Committee and the Auditor General. The costs of remodeling this space and providing office furniture were paid by the Assembly Rules Committee from the Assembly Contingent Fund.

Recruitment of Audit Staff

The committee in its meeting held May 17, 1956, voted unanimously to recruit a staff for the Office of the Auditor General exempt from civil service as permitted by the Joint Rules of the Senate and the Assembly. Because of the complexities and magnitude of the auditing task to be performed, high standards of competence were established as prerequisites. These standards generally are:

- A bachelor's degree or higher with a major in accounting from a recognized college or university;
- Possession of a certified public accountant's certificate, at least at the higher staff levels;
- Progressive, diversified experience with a firm of independent certified public accountants of some substance;
- The ability to work with others on a professional plane;
- A high degree of personal integrity; and
- An unusual amount of curiosity, industry, perseverance, and resourcefulness.

Price Waterhouse & Co. in its report in 1954 proposed that the functions of the Auditor General be performed with a staff of about 30 to 40 auditors. On October 26, 1956, the committee tentatively approved a staff of three audit managers, 12 senior accountants, and 12 semisenior accountants. It was the policy of the committee to

employ the audit staff gradually starting with the higher level positions first. The adding of audit staff at the junior accountant level was deferred until audit plans could be formulated and an over-all appraisal made of the audit problem. The recruiting of junior accountants began in January, 1958.

A complete roster of employees of the Office of the Auditor General is included as Appendix B. The employment and separation of members of the audit staff is summarized by years as follows:

1956—employed		18
1957:		
Employed	8	
Separated	1	7
	—	—
Audit staff at December 31, 1957		25
1958:		
Employed	8	
Separated	5	3
	—	—
Audit staff at December 31, 1958		28

Of the 34 accountants who were employed for the audit staff, 16 were certified public accountants at the time they joined the staff of the Auditor General, and four received their certificates after joining the staff. At December 31, 1958, 15 of the 28 staff members are certified public accountants. One staff member has written the examination successfully but the issuance of a certificate has been deferred until experience requirements have been fulfilled. The remaining 12 members who are non-CPAs are qualified by education to write the examination for certified public accountant. Seven of the 12 wrote the examination in November, 1958. The results of this examination have not yet been announced.

The composition of the staff at December 31, 1958, by classes of accountants is as follows:

	Total	CPAs	Average Age
Audit managers	3	3	38
Seniors	10	8	32
Semiseniors	7	4	32
Juniors	8		29
	—	—	—
Total	28	15	32

The audit managers, the senior accountants and semisenior accountants had several years of experience on audit staffs of public accounting firms prior to their recruitment for the staff of the Auditor General.

Legislative Audit Advisory Board

At its meeting on October 24, 1958, the Joint Legislative Audit Committee adopted a resolution creating a Legislative Audit Advisory Board to provide technical counsel to the committee on accounting and auditing matters as requested by the committee. The advisory board is to consist of seven members who have gained recognition for

high professional achievement in public accounting in California. They are to be appointed by the committee and it is expected that lists of proposed members will be submitted by the California Society of Certified Public Accountants and similar organizations. The members are to serve without compensation except for reimbursement for expenses in attending meetings. It is expected that the first members of the advisory board will be appointed early in 1959.

ACTIVITIES OF THE OFFICE OF THE AUDITOR GENERAL

The first assignment of the Auditor General was a special study of the State's claim processing procedures in the Office of the State Controller and in selected state agencies. This study was requested by a subcommittee of the Senate Finance Committee.

The general audit program of the Office of the Auditor General was started with an over-all study of the system of internal control in state agencies to determine how much reliance could be placed on reports of these agencies. While the State Government as a whole may be compared with big business, its functions are carried out through highly dispersed operations. Many of these operations are comparatively small with resultant weaknesses in controls which are usually associated with small businesses. As a result of these studies recommendations have been made to provide the maximum safeguards practicable with due consideration to the cost of maintaining controls.

Upon completion of the studies of internal control the Auditor General was directed to make audits of selected funds and agencies for the year ended June 30, 1957. The smaller funds which account for the operations of one or two agencies or which are maintained solely by a single agency were selected for these first audits. Beginning in the early part of 1958, audits were started for the year ending June 30, 1958. The program for this period included the audit of many General Fund agencies.

In January and February, 1959, it is planned to start interim work on audits for the year ending June 30, 1959. The effort of the audit staff will be directed to General Fund agencies with the objective of expressing an opinion on the fairness of the financial statements of that fund as of June 30, 1959.

The Auditor General has made special studies for Senate and Assembly interim committees as assistance has been requested from time to time. The Joint Legislative Audit Committee has offered the services of the Auditor General to the Rules Committees of the Senate and the Assembly for the audit of legislative funds.

A summary of direct time reported on assignments by the Office of the Auditor General, classified by functions of State Government, is presented as Appendix C.

The activities of the Office of the Auditor General are presented in greater detail below.

Study of Claim Processing Procedures

The first task assigned to the Auditor General was a study of the State's claim processing procedures as they relate to disbursements other than payroll. In his 1955-56 Budget Analysis, the Legislative Analyst maintained that the State Controller was performing much unnecessary and duplicate work in his Bureau of Claim Audits and recommended that a substantial reduction in positions in that bureau be made. As a result of this recommendation, the Senate Finance Committee requested that the Controller, the Department of Finance and the Legislative Analyst study the preaudit function in the Controller's office. In accordance with this request, the Budget Division of the Department of Finance made a study and reported that the program of the bureau could be curtailed and the staff reduced from 48 to 24 positions. The Legislative

Analyst, in his analysis of the 1956-57 Budget, agreed with this report and recommended that the staff be reduced.

A subcommittee of the Senate Finance Committee in a report dated March 16, 1956, on its hearings on the State Controller's General Fund budget for the Fiscal Year 1956-57 recommended that the Auditor General report to the Joint Legislative Budget Committee on the recommendations of the Legislative Analyst.

The Auditor General studied the claim processing procedures in the Office of the State Controller and in representative agencies of State Government which included tests in all of the departments of the State Government. The report on this study was presented at the February 28, 1957, meeting of the committee. The principal recommendations were as follows:

That the final authority for the approval of claims prior to payment be placed with the chief administrative officers of the various agencies,

That the statutory duties of the State Controller as they relate to the audit of claims against the State be changed to relieve him from liability with respect to warrants drawn in reliance upon certification of claim schedules by authorized employees of state agencies, and

That the State Controller's examination of claim schedules submitted by state agencies be limited to a determination (1) that the claim schedules are certified by properly designated agency representatives, (2) that the appropriations shown on the claim schedules are available to the particular agencies, and (3) that sufficient unexpended balances are available to cover the amounts claimed.

These recommendations were based on findings that the procedures prescribed by the Department of Finance for the processing of claims in state agencies under the decentralized system of accounting provided an adequate system of internal control over expenditures. Therefore, it was concluded that the claim checking performed by the State Controller's Bureau of Claim Audits was an unnecessary duplication and should be restricted to the three steps stated above.

The Legislative Counsel expressed his opinion that the provisions of the Constitution relating to the Office of Controller do not preclude the Legislature from providing for the audit of claims by the individual state agencies prior to their submission to the Controller, nor from requiring such agencies to certify to the correctness and legality of the claims so audited and relieving the Controller from liability with respect to warrants drawn in reliance upon such certifications.

The Deputy Director of the Department of Finance agreed with the recommendations and estimated that their adoption would result in an annual savings of \$250,000.

The committee voted to transmit the report of the Auditor General to the Senate Finance Committee with a recommendation that they take appropriate action, and directed that the Chairman of the Joint Legislative Audit Committee introduce legislation to put these recommendations into effect. Bills were introduced by Assemblyman Caldecott in the 1957 Session and referred to the Assembly Ways and Means Committee. The bills were not voted out of that committee.

Review of System of Internal Control

On October 26, 1956, the committee instructed the Auditor General to concentrate his efforts on a review of the system of internal control in all departments and agencies of the State Government for the purpose of determining the soundness of accounting procedures and the dependability of accounting records and reports.

The importance of acquiring and maintaining an effective system of internal control in the State Government is manifested in the following factors, which are adapted from points enumerated in internal control information published by the American Institute of Certified Public Accountants:

The scope and size of state activities have grown to the point where the organization has become complex and widespread. To control operations effectively the management must depend on the reliability of numerous reports and analyses.

The primary responsibility for safeguarding the assets of the State and preventing and detecting errors and fraud rests on the management of departments and agencies. An adequate system is indispensable to a proper discharge of that responsibility.

The protection which a good system of internal control affords against human weaknesses is of great importance. The check and review which is inherent in a good system reduces the possibility that errors or fraud will remain undetected for any long period, and enables management to place greater confidence in the reliability of data submitted.

It is impracticable to make detailed audits of all departments and agencies because of the excessive cost that would result. Also, a subsequent examination is not a substitute for proper controls in the actual handling of transactions.

Internal control is defined as follows:

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within the government to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

This definition recognizes that a system of internal control extends beyond those matters which relate directly to the functions of accounting and finance. The characteristics of a satisfactory system of internal control include:

A plan of organization which provides appropriate segregation of functional responsibilities.

A system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues and expenses.

Sound practices to be followed in the performance of duties and functions of each of the departments and agencies.

A degree of quality of personnel commensurate with responsibilities.

The essence of an effective system of internal control is the segregation of duties in such a way that the persons who are responsible for the custody of the assets and conduct of the operations have no part in the keeping of, and do not have access to, the records which establish accounting control over the assets and the operations. Duties of individuals should be so divided as to minimize the possibility of collusion, perpetration of irregularities and falsification of the accounts. The objective is to provide the maximum safeguards practicable in the circumstances, giving due consideration to the risks involved and the cost of maintaining the controls.

The characteristics of internal control enumerated above as they apply to the Executive Branch of State Government are fixed by the State Constitution, by state statutes, and by administrative rules.

The State Constitution has much influence on the plan of organization, as it establishes the 11 separate elective officers which head the Executive Branch of the government. This diffusion of authority and responsibility for administration of the State Government has been criticized by legislative committees, civic groups, students of government, and others. This diffusion of authority, sometimes confused with the principle of checks and balances (which actually applies to the traditional division of government into Legislative, Executive, and Judicial Branches and is not a principle which requires hobbling the Executive Branch) is a hindrance rather than an aid to a sound system of internal control.

The arrangement of departments and boards and the assignment of the functions of government to these groups is accomplished primarily by the enactment of statutes by the Legislature. The establishment of lines of authority and division of duties within organizational divisions of government are generally the responsibility of those divisions. Although the entire plan of organization is important in obtaining internal control, consideration by the Auditor General of the plan of organization has been limited at this time to the segregation of duties at the lower levels of State Government.

The establishment of an adequate system of authorization and record procedures is the responsibility of the Director of the Department of Finance, as is the responsibility for prescribing sound practices to be followed in the performance of duties and functions. The Director of the Department of Finance has published a State Administrative Manual to fulfill his responsibilities in this respect.

It is the responsibility of the State Personnel Board to provide "a degree of quality of personnel commensurate with responsibilities."

The studies of the system of internal control in State Government were made at more than 150 locations throughout the State. Twenty-seven reports on these studies have been made. These reports are listed by functions of State Government in Appendix D. Reports have not been issued in those cases in which the deficiencies disclosed were relatively immaterial or the accounting transactions were immaterial.

The system of internal control in the various state agencies studied was appraised by obtaining answers to a specially designed internal control questionnaire, from employees engaged in the recording of transactions or in the other activities reviewed. The internal control questionnaire used for this purpose is divided into 16 sections as follows:

JOINT LEGISLATIVE AUDIT COMMITTEE

<i>Section</i>	<i>Number of questions</i>	<i>Section</i>	<i>Number of questions</i>
General	13	Purchases and accounts	
Mail	8	payable	19
Cash receipts.....	18	Inventory and stores	
Cash disbursements	13	operation	33
Cash—general	3	Farm and processing	
Cash—revolving fund.....	17	operations	19
Securities	9	Property	34
Accounts receivable	23	Trusts	23
Payroll	28	Services furnished employees	13
Travel	9		
		Total	282

The deficiencies disclosed by answers to these questionnaires were reviewed with supervisory personnel in the agencies studied. Deficiencies were also reviewed with supervisory staff of the Audits Division of the Department of Finance in order to come to a common understanding of the deficiencies in the various agencies.

In those cases in which formal reports on internal control have been issued, the committee has received replies from the agencies indicating whether or not they have accepted the recommendations made for improvement in internal control. Most of the weaknesses in internal control that have been disclosed by the studies were due to failure of the agencies to follow procedures prescribed by the State Administrative Manual. The co-operation by state agencies in efforts to strengthen internal control has been very good. *The replies received from the agencies indicate that there was prompt concurrence with about 75 percent of the recommendations made.* As to many of the recommendations which were not adopted immediately, the agencies agreed to make further studies and take the action that such studies indicated was advisable. In many cases the reports of the Auditor General have called attention to deficiencies in accounting methods and procedures, and recommendations have been made that the Division of Organization and Cost Control of the Department of Finance make special studies. That division has been very co-operative in these cases and has either made the suggested studies or has made arrangements to make the studies as soon as the limitations of their staff will permit.

During the year 1958 several defalcations of state funds have occurred because of deficiencies in systems of internal control. The defalcations that have been brought to the attention of the Auditor General are described in Appendix G.

As was stated above, it is recognized that a system of internal control extends beyond those matters which relate directly to the functions of accounting and finance. During a study of the system of internal control in the Department of Justice, deficiencies in the control of confiscated narcotics were observed and recommendations were made for changes to improve these controls. After the completion of this study, but prior to the issuance of a report, the department received a great deal of adverse publicity because of reported laxness in the handling of confiscated narcotics by its agents in the field. The attention drawn to these matters resulted in the development by the department of a manual of instructions for the Bureau of Narcotic Enforcement. This manual covers, generally, the responsibilities and personal conduct of bureau employees,

reporting and filing procedures, field office operations, and the processing of and accountability for narcotics.

The procedures for the control of narcotics were reviewed with representatives of the Department of Justice at the September 22, 1958, meeting of the committee, and the department volunteered to add two additional controls over stored narcotics which would not involve any additional cost.

The review of the system of internal control is the initial step in an audit program. As audits are made of the various agencies there will be an opportunity to observe and verify the changes made to improve controls.

Audits of State Agencies

As studies of the system of internal control in selected agencies of the State Government were completed, audits were started of state funds and agencies for the fiscal year ended June 30, 1957, and December 31, 1957. For the first audits, funds which are used to record the transactions of just one or two agencies were selected. Audits of more than 50 funds for the year ended June 30, 1957, and one for the year ended December 31, 1957, have been completed. Audits are in progress in about 25 agencies of the State Government for the year ended June 30, 1958.

For these first audits of funds and agencies long-form reports have been issued. The first paragraph of this type of report generally sets forth representations regarding the scope of the audit. The second paragraph deals with findings. These findings are expressed in the form of an opinion concerning the fairness with which the financial statements present the financial position of the fund or agency as of the end of the period audited and the results of operations for the period.

Opinions have been qualified in those cases in which the examination was not sufficiently complete to warrant the expression of an unqualified opinion or when violations of generally accepted accounting principles were not corrected. The Auditor General has refrained from expressing either an unqualified or a qualified opinion in those cases in which the exceptions or reservations, because of limitation in scope of audit or because of departures from generally accepted accounting principles, have been such as to destroy the significance of the opinion on the statements taken as a whole. In each case in which an opinion has not been expressed the reason for omission of an opinion has been stated.

In addition to the scope paragraph and the opinion paragraph, the long-form reports contain historical data on the funds or agencies audited, comments on operations and significant balance sheet items, and comments on internal control findings and other important matters.

The reports which have been issued to December 31, 1958, are shown in Appendix D. The reports which were in process on assignments for which field work had been completed at December 31, 1958, are shown in Appendix E. The audits which were in process at December 31, 1958, are shown in Appendix F.

In each of the audit reports issued by the Office of the Auditor General the standard scope and opinion paragraphs recommended by the American Institute of Certified Public Accountants have been included, as follows:

"We have examined the balance sheet of a fund of the State of California as of June 30, 19____, and the related statement of revenues, expenditures, and unappropriated surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"In our opinion, the accompanying balance sheet and statement of revenues, expenditures, and unappropriated surplus present fairly the financial position of a fund of the State of California as of June 30, 19____, and the results of its operations for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

The above-quoted paragraphs have been modified in some of the audit reports issued by the Office of the Auditor General because in those instances a qualified opinion or denial of opinion was required because: (1) generally accepted accounting principles had not been followed in recording transactions of the fund; or (2) the scope of the examination was too limited to permit the issuance of an unqualified opinion; or (3) adequate informative disclosure of material items had not been made in the financial statements.

In the first of the two paragraphs quoted above, reference is made to an "examination" of the financial statements having been made in accordance with "generally accepted auditing standards," and in the second paragraph reference is made to the application of "generally accepted accounting principles" by the fund under audit. The following paragraphs contain definitions of these terms as they are used by the Office of the Auditor General, which usage coincides with that of firms of certified public accountants.

The term "examination" of financial statements is used to mean a critical analysis of the underlying internal controls and accounting records of an operating entity of sufficient scope to warrant the expression of an opinion as to the propriety of the financial statements prepared from those records. To examine the financial statements of funds of the State of California, the Office of the Auditor General must audit the accounting records of the operating agencies where the financial transactions originate as well as the control accounts maintained by the State Controller.

The term "generally accepted auditing standards" is used to mean the broad standards specified by the American Institute of Certified Public Accountants and widely adopted and adhered to by firms of certified public accountants, as follows:

General standards:

- (1) The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
- (2) In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
- (3) Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of field work:

- (1) The work shall be planned adequately and assistants, if any, are to be supervised properly.

- (2) There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon, and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
- (3) Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Reporting standards:

- (1) The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
- (2) The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
- (3) Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- (4) The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

In addition to these broad auditing standards, which have been generally accepted by professional auditors, there are many more specific supplementary standards and rules which have been widely adopted by practitioners as guides for quality of performance. To implement these standards and rules, a great many auditing procedures and techniques have gradually been devised and are employed by practitioners in situations where, in the judgment of each practitioner, they are applicable. The Office of the Auditor General adheres to the above-listed standards and utilizes all of the auditing procedures considered necessary in the circumstances surrounding each examination.

The term "generally accepted accounting principles" in the opinion paragraph quoted above refers to those principles involved in recording accounting transactions which have been generally considered to be the most useful in presenting fairly the financial position and results of operations of an operating entity. In governmental accounting there has not been a long enough period of experience to establish a set of principles that has been universally accepted. However, in governmental accounting a number of principles which apply to all accounting processes and some principles which are peculiar to fund accounting have gained substantial recognition.

The National Committee on Governmental Accounting, consisting of 10 advisory committees from leading accounting organizations in the United States, has formulated a body of accounting principles which are recommended as being generally applicable to governmental entities. The advisory committees represent the following organizations:

American Accounting Association;
American Institute of Certified Public Accountants;

American Municipal Association;
International City Managers' Association;
Municipal Finance Officers Association;
National Association of Accountants;
National Association of State Auditors, Comptrollers and Treasurers;
National Association of State Budget Officers;
National Municipal League;
United States Federal Government:
 Treasury Department;
 Federal Security Agency;
 General Accounting Office;
 Bureau of the Budget.

The 14 accounting principles recommended by the National Committee on Governmental Accounting are as follows (with the wording amended slightly to apply to governmental organizations in general):

- (1) A governmental accounting system must make it possible: (a) to show that legal provisions have been complied with; and (b) to reflect the financial condition and financial operations of the government.
- (2) If legal and sound accounting provisions conflict, legal provisions must take precedence. It is, however, the finance officer's duty to seek changes in the law which will make such law in harmony with sound accounting principles.
- (3) The general accounting system should be on a double-entry basis with a general ledger in which all financial transactions are recorded in detail or in summary. Additional subsidiary records should be kept where necessary.
- (4) Every governmental organization should establish the funds called for either by law or by sound financial administration. It should be recognized, however, that funds introduce an element of inflexibility in the financial system. Accordingly, consistent with legal provisions and requirements of sound financial administration, as few funds as possible should be established.
- (5) Depending on the legal and financial requirements mentioned immediately above, the following types of funds are recognized: (a) general, (b) special revenue, (c) working capital, (d) special assessment, (e) bond, (f) sinking, (g) trust and agency, and (h) utility or other enterprise. This classification of funds to the extent required should be followed in the budget document and in the governmental organization's financial reports.
- (6) A complete balancing group of accounts should be established for each fund. This group should include all of the accounts necessary to set forth the financial condition and financial operations of the fund and to reflect compliance with legal provisions.
- (7) A clear segregation should be made between the accounts relating to current assets and liabilities and those relating to fixed assets and liabilities. With the exception of working capital, utility or other enterprise, or trust funds, fixed assets should not be carried in the same funds with the current assets but should

be set up in a self-balancing group of accounts known as the general fixed asset group of accounts. Similarly, except in special assessment and utility funds, long-term liabilities should not be carried with the current liabilities of any fund but should be shown in a separate self-balancing group of accounts forming part of the general bonded debt and interest group of accounts.

- (8) The fixed asset accounts should be maintained on the basis of original cost, or the estimated cost if the original cost is not available, or, in the case of gifts, the appraisal value at the time received.
- (9) Depreciation on general governmental fixed assets should not be computed unless cash for replacements can legally be set aside. Depreciation on such assets may be computed for unit cost purposes even if cash for replacements cannot legally be set aside providing these depreciation charges are used for memorandum purposes only and are not reflected in the accounts.
- (10) The accounting system should provide for budgetary control for both revenues and expenditures, and the financial statements should reflect, among other things, budgetary information.
- (11) The use of the accrual basis in accounting for revenues and expenditures is recommended to the extent applicable. Revenues, partially offset by provisions for estimated losses, should be taken into consideration when earned, even though not received in cash. Expenditures should be recorded as soon as liabilities are incurred.
- (12) Revenues should be classified by fund and source; and expenditures by fund, function, department, activity, character, and by main classes of objects, in accordance with standard classifications.
- (13) Cost accounting systems should be established wherever costs can be measured. Each cost accounting system should provide for the recording of all of the elements of cost incurred to accomplish a purpose, to carry on an activity or operation, or to complete a unit of work or a specific job. Although depreciation on general governmental fixed assets may be omitted in the general accounts and reports, it should be considered in determining unit costs if a cost accounting system is used.
- (14) A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports.

The Office of the Auditor General has taken the position that principle (7) above is not necessarily applicable to state governments, but that otherwise the accounting principles enumerated above are applicable to the State of California and to other state governments. In expressing an opinion as to whether the financial statements of a fund of the State of California present fairly the financial position of the fund as of a given date and the results of operations for the period ended on that date in conformity with generally accepted accounting principles, the criteria used by the Office of the Auditor General have been the principles of the National Committee on Governmental Accounting set forth above, together with other principles applicable to both governmental and private organizations.

Reports have been issued with qualified opinions in three cases and opinions have been disclaimed in three cases. In the case of the Department of Water Resources an audit could not be made because of the condition of the records. The circumstances of each of these cases are discussed below:

Surplus Money Investment Fund

The opinion expressed by the Auditor General on the fairness of the financial statements of the Surplus Money Investment Fund for the year ended June 30, 1957, was qualified because no systematic amortization of discount or premium over the term of ownership of the securities was recorded on the books of the fund. Discounts on securities purchased had been taken into income and the securities were being carried at par. As a result, principal of the fund had been distributed as income to the participating funds.

Studies have been reinstated by the State Controller's office and the Department of Finance for the purpose of devising a system for recording securities that will be applicable to all funds.

Real Estate Fund

In the case of the Real Estate Fund, the opinion on the financial statements was qualified as to the consistency of application of generally accepted accounting principles. Legislation had been enacted in 1956 placing the renewal of license fees on a four-year cycle basis. As a result of this change there was a substantial distortion in the relationship of revenues to expenditures for the year ended June 30, 1957.

Board of Pilot Commissioners' Special Fund

The opinion on the financial statements of the Board of Pilot Commissioners' Special Fund for the year ended June 30, 1957, was qualified because of a limitation on the verification of the recorded revenues of the fund. The revenues of the fund are based on pilotage fees received by the pilots and reported by the San Francisco Bar Pilots Association, an association owned and operated by the licensed pilots. The records of the San Francisco Bar Pilots Association were not examined by the Auditor General.

Arrangements have been made to verify pilotage fees through audits by the Audits Division of the Department of Finance or by review of reports of independent auditors.

State Printing Fund

In the case of the examination of the State Printing Fund for the year ended June 30, 1957, an opinion on the fairness of the financial statements was disclaimed for the following reasons:

The scope of the examination did not include tests of physical inventory quantities or observance of physical count of inventory at the beginning and end of the year.

Generally accepted principles of accounting were not observed or were not consistently applied in the following instances:

- (a) The accrual basis of accounting had not been observed:
 - (1) Some jobs which were completed and shipped before June 30, 1957, were not billed at that date but were included in work in process inventory.

- (2) In some cases the cost of materials purchased for inventory and equipment received before June 30, 1957, were not recorded in the accounts.
- (b) A consistent policy had not been established and followed in the setting of the estimated useful lives in providing for depreciation of equipment.
- (c) A reserve for sick leave totaling \$440,000 had been provided by charges to operations in excess of actual cost of sick leave incurred, including \$82,000 in the year ended June 30, 1957.

The financial statements did not provide adequate informative disclosure. Charges for services had been made at prices in excess of cost contrary to the provisions of the Government Code. Earnings of \$3,700,000 had been accumulated and used to augment the capital of the fund without legislative approval.

Shorthand Reporters' Fund

The financial statements of the Shorthand Reporters' Fund did not present fairly the financial position of the fund as of June 30, 1957, and the results of operations for the year then ended because \$10,380 of collections were recorded as deferred income instead of revenue for the year.

California Olympic Commission

The financial statements of the California Olympic Commission did not present fairly the financial position of the fund as of June 30, 1958, and the results of its operations for the period from September 7, 1955, to June 30, 1958, for three reasons:

1. Work in progress totaling \$968,000 had been omitted from the balance sheet.
2. Encumbrances of \$3,600,000 had been shown in the financial statements as expenditures and as accounts payable.
3. Accounts receivable totaling \$333,000 had been omitted from the balance sheet and a like amount of reimbursements had been excluded from the statement of expenditures.

Section 16304 of the Government Code gives statutory authority to consider an appropriation "to be expended at the time and to the extent that it has been encumbered by the creation of a valid obligation on the part of the State of California." However, in accordance with generally accepted accounting principles a liability is not established nor an expenditure made until goods have been delivered or services performed.

Department of Water Resources

The Auditor General started interim audit work in February, 1958, on the accounts of the Department of Water Resources for the year ending June 30, 1958. After applying various audit procedures over a period of several weeks it was concluded that an audit of the department was not feasible. Enough audit work was performed by the Auditor General to determine the nature of some of the deficiencies in the accounting records. As a result a report entitled "Report on Special Investigation of Accounting Procedures and Records of the Department of Water Resources for the Year Ended June 30, 1958" was issued and presented to the committee at its meeting on September 22, 1958.

The Auditor General recommended:

That an immediate study be made of the accounting system of the Department of Water Resources by the Department of Finance and that they design an accounting system to furnish the necessary accounting records and controls needed by the department for efficient and economical operation; and that immediate assistance be given to the department to bring the records up to date and put them in an acceptable condition.

The Department of Finance agreed to assist the Department of Water Resources with these accounting problems. Reports were made at meetings of the committee held on October 24 and December 5, 1958, on the progress made in the elimination of deficiencies.

The Department of Finance reported that they had five employees from the Audits and Organization and Cost Control Divisions working on management control and accounting problems including the design of an accounting system adapted to the special needs of the Department of Water Resources. The Department of Water Resources reported that they had added two account clerks to their staff, that an assistant accounting officer would be added by the end of the year, and that they were taking steps to add an internal auditor to their staff.

It is expected that the new system which is being designed will be in operation by July 1, 1959. The Auditor General was instructed to keep in touch with the setting up of the new system so that the committee might be satisfied that it will be adequate.

Co-ordination of Audit Activities

On October 6, 1958, the Auditor General, the Deputy Auditor General and the three audit managers of the Office of the Auditor General met with the Chief, and the supervising state financial examiners of the Audits Division of the Department of Finance. There was an open discussion of ways and means of co-ordinating the work of the two offices to secure timely audit coverage that would permit the Audits Division to comply with the requirements under which they operate and to permit the Office of the Auditor General to make timely reports to the Legislature as required by the law which established the Office of Auditor General. At this meeting a special committee composed of two audit managers from the Office of the Auditor General and two supervising financial examiners from the Audits Division was appointed to formulate a general plan under which these objectives could be accomplished and specifically to plan a program for the two audit agencies for the year ending June 30, 1959, to provide audit coverage that would permit the expression of an opinion by the Office of the Auditor General on the financial statements that will be presented for the General Fund of the State of California as of June 30, 1959.

This special committee issued its report on October 15, 1958, in a letter addressed to the Auditor General and to the Chief of the Audits Division of the Department of Finance. The report was discussed at a joint meeting of the aforementioned management groups of the Office of the Auditor General and the Audits Division on November 3, 1958.

Based on the review and discussion of the recommendations of the special committee, it was the consensus of the group that the following-described general plan would be the most feasible for the two audit groups and would most nearly achieve the objectives set up for the two offices with a minimum of duplication of effort and provide the State with a maximum of audit coverage. This plan was adopted on the basis that there would be no material increase in the size of the staff of either agency.

The general plan is as follows:

1. The Audits Division will adopt a June 30th ending date for its examinations with some exceptions. This is a change from their present practice of making examinations as of the end of various quarters during the year.
2. The Audits Division, being required by law to make examinations of the records of state agencies at least once every two years, will examine the records of one-half of the agencies as of June 30, 1959, and the other half as of June 30, 1960. The Auditor General will select for examination at June 30, 1959, agencies not scheduled for examination by the Audits Division in the same year. Based on the staff available, the Auditor General should be able to cover at least one-half of the agencies not covered by the Audits Division, or one-fourth of the total agencies of the State each year. This practice would provide audit coverage on a combined basis of approximately three-fourths of all agencies each year, and with certain exceptions, the Office of the Auditor General would cover all agencies once each four years. If feasible, certain agencies may be examined more frequently because of the nature and significance of their operations.
3. The Audits Division will attempt to complete the examinations of the financial statements of the agencies which they are to audit for the year ending June 30, 1959, by November 30, 1959. They will notify the Auditor General upon completion of an audit of an agency that they have examined the financial statements of the agency for the year and that the statements were substantially correct and conformed in all material respects with the requirements of the State Administrative Manual or present any major exceptions they may have regarding the agency's financial statements.
4. The Auditor General will review the audit reports, interim letters, and working papers prepared by the Audits Division to the extent that he considers necessary in each case for the purpose of determining the adequacy of the auditing performed by the Audits Division and the adequacy of the financial statements of the agencies audited by the Audits Division.
5. The Auditor General will review the State Controller's Annual Report and the financial statements included in the Governor's Budget. This review will include the comparison of agency statements for the year with the Controller's report and the budget.

There are several advantages to the plan as compared with other possible alternative plans. One is that it will, to a large extent, eliminate duplication of auditing by the two agencies. Ordinarily an agency will be audited by only one group of auditors in any year; it will not have two separate audits of the same transactions.

The plan will permit the Audits Division to carry on its internal audit activities with a minimum of interference and still provide the Auditor General a basis for review of activities of agencies which the Auditor General has not audited during a particular year.

The plan will provide the widest audit coverage of the State with the staffs available to the two agencies and will provide a basis for reasonably timely reporting of audit findings. With proper planning a large percentage of the audit work for a fiscal year can be completed prior to the end of the fiscal year.

Future Program

It is expected that audits for the year ended June 30, 1958, will be completed by the end of January, 1959, and the staff of the Auditor General will then start interim work on audits for the year ending June 30, 1959. This work will be concentrated on agencies supported by the General Fund with the intent of obtaining sufficient audit coverage of those agencies to enable the Auditor General to express an opinion on the financial statements of the General Fund for the year ending June 30, 1959. As previously mentioned, the intent of the arrangement with the Audits Division of the Department of Finance for co-ordination of the audit activities of the two offices is to provide for the continuance of the biennial audits of the Audits Division as required by law, and to enable the Auditor General to cover each agency every four years with his staff and to review enough of the work of the Audits Division to justify the expression of an opinion on the financial statements of many funds and agencies annually.

Without this plan of co-ordination the audit coverage of the Office of the Auditor General would be materially reduced, and even with the plan in effect there appears to be a serious question as to the possibility of obtaining adequate audit coverage for the Department of Employment and the Division of Highways of the Department of Public Works. These two agencies present special problems because of their size and widely dispersed operations. It appears that the Division of Highways will particularly require substantial audit effort because of: (1) its large expenditures to private contractors; (2) the authority delegated to field engineers in dealing with contractors; (3) its needlessly complex and intricate accounting system which provides for a pyramid of overhead charges and elaborate allocation of expenses; and (4) perhaps most important, the limited legislative control over its activities.

Experience under the plan of co-ordinated effort with the Audits Division of the Department of Finance, with full utilization of the work of the internal auditors employed by some of the agencies, will be required over a period of time to permit a determination as to whether the optimum audit coverage is being obtained by the Office of the Auditor General under the plan outlined above.

The fields in which it appears that the committee will be able to work most productively for the benefit of the State of California are: (1) continued reviews of the findings and recommendations of the Office of the Auditor General relating to improvements in internal control and other accounting processes and insistence on their adoption, (2) recommendations for statutory changes in those instances where legal

requirements conflict with generally accepted principles or practices of accounting and therefore restrict sound recording and reporting of financial transactions of the State, and (3) recommendations for elimination of unnecessary expenditure of funds resulting from cumbersome organization and procedures.

The committee believes that it should interest itself not only in matters which are within its sole province as an auditing committee, but, in addition, believes that it has the duty of examining other governmental matters involving organization and economy which are brought to its attention through the work of the Auditor General and which are the special concern of other legislative committees so it may refer such matters to those committees or to appropriate agencies in the executive branch for study and action. As the Office of the Auditor General completes audits of state funds and agencies it will be in a position to observe and call to the attention of the committee opportunities for effecting economies and improving organization. It is expected that some of the important areas which will present these opportunities are:

- (1) Simplification of the fund structure in state accounting. Elimination of many unnecessary funds among the total of more than 200 now in use could substantially reduce accounting work.
- (2) Forms control. The cost of producing and processing unnecessary and poorly designed forms could be saved by the institution of proper controls over all forms used.
- (3) Paper work simplification. The elimination of compilations of unnecessary and unused statistical data, the discontinuance of duplicating the recording of operating information, etc., could result in substantial savings.
- (4) Performance standards. The establishment of criteria for measuring the quantity and quality of work that each employee should produce each day is one of the most important controls that can be obtained over payroll, which is the major cost of state operations.

It is anticipated that these and other problems not directly related to auditing will be brought to the attention of the committee for reference to others to devise improvements that will be of benefit to the entire State.

EXPENDITURES

Funds for the operation of the committee and the Office of the Auditor General are allotted from the Assembly Contingent Fund and the Senate Contingent Fund in equal amounts and concurrent resolution of the Legislature authorizes expenditure until an amount of one-half allotment has been spent.

STATEMENT OF EXPENDITURES TO DECEMBER 31, 1958

	1956	1957	1958
Salaries	\$42,710	\$21,710	\$21,210
Travel expenses	801	1,201	1,201
Supplies, services, etc.	3,201	1,701	1,341
Committee expenses	2,231	1,231	1,341
Equipment	2,604	1,204	672
	<hr/>	<hr/>	<hr/>
Less reimbursements	59,560	12,120	1,170
	<hr/>	<hr/>	<hr/>
	\$50,560	\$21,120	\$27,038

STATEMENT OF CHANGES IN ALLOTMENT ACCOUNT TO DECEMBER 31, 1958

	1956	1957	1958
Allotment available at beginning of year		\$120,431	\$276,799
Allotments:			
Transfer from General Fund, May, 1956	\$30,000		
General Fund appropriation, July, 1956			
(\$17,468 reverted at June 30, 1957)	15,532		
Allotments from Assembly and Senate Contingent Funds			
	<hr/>	<hr/>	<hr/>
Less:			
Reimbursements			
	<hr/>	<hr/>	<hr/>

APPENDIX A

COMMENTS ON SCOPE OF AUDITING FOR JOINT LEGISLATIVE AUDIT COMMITTEE

By Legislative Analyst

October 24, 1955

A. General

The scope and extent of the auditing which should be performed by the Auditor General under Chapter 1699/1955 is a matter which does not readily lend itself to a precise definition since it depends to a considerable degree upon the auditing being done at other levels in the State Government.

In large corporate enterprises current practice recognizes auditing carried on at three distinct levels: at the operating level, at the top management level, and at the proprietary level.

In a large oil company, for example, an operating department, such as the marketing department, would have internal auditors reporting directly to the head of that department whose function would be to examine the transactions in service stations, bulk plants and other units of the marketing department to see that they were being properly handled and to satisfy the head of that department that his instructions were being carried out and his staff was doing an honest and efficient job. This type of auditing can properly be described as internal auditing at the operating level.

In the same company another group of auditors reporting directly to an appropriate top level official, such as the president, controller, et cetera, would be responsible for review of all corporate operations, including the preparation of financial statements. An important part of the responsibility of this group would be an evaluation of the work of the internal auditors at the departmental level, but it would not involve a duplication of the work of the latter except to the extent necessary to determine that they were doing an adequate job, and the work of the two groups would involve a high degree of co-operation. This type of auditing can be described as internal auditing at the top management level. At the third level, independent auditing would be done by outside public accountants reporting to the stockholder, either directly or through the board of directors, whose responsibility would be to report on the fiscal activities of the corporation as a whole. One important part of the work of these auditors would be the evaluation of the work of the two groups of internal auditors and the scope of their work would depend on the adequacy of the job being done by the internal auditors and the degree of co-operation received from them, which in typical corporate operations is very high because of the existence of the profit motive.

The determination of the extent of the work of the auditors at the three different levels is a matter of prudent business management and may vary according to conditions, but the entire audit operation is essentially an integrated whole, and the responsibilities of each group to its "client" are essentially the same.

The extent of the work of the outside public accountants would in any case be directly related to the adequacy of the work of the two groups of internal auditors.

The report of Price Waterhouse & Co. recognizes the existence of and the necessity for internal auditing at two levels within the State Government. These are roughly comparable to those found in private industry, i.e., the departmental internal auditors in the Departments of Public Works, Employment, Motor Vehicles, et cetera, are comparable to those in the marketing department of the corporation used as an illustration, while the auditors in the Department of Finance are comparable to those reporting to the president or controller.

The report also recommends the establishment of a third level, or an independent audit responsible to the Legislature, such as that provided for in the Auditor General Bill, Chapter 1699/1955, which it envisions as partaking of many of the characteristics of the work performed by outside public accountants for private industry as referred to in the foregoing illustration.

The proper extent of this independent auditing is difficult to describe in precise terms, since it depends to a large extent upon the nature and scope of the internal auditing carried on at the two levels and upon the degree of co-operation existing between the three levels of auditors. It is, therefore, largely a matter of judgment and we know of no more reliable judgment available than the professional opinion expressed in the Price Waterhouse & Co. report which will be discussed later. Certainly, as a bare minimum it should be extensive enough to permit the Legislature to receive an independent evaluation of the adequacy of all internal auditing carried on within the State Government.

B. Policy as indicated in the law and Price Waterhouse & Co. report

Pertinent statements in the law appear to be the following:

“Section 10500. The Legislature, also, recognizes the necessity of an independent audit, in addition to the audit conducted within the executive branch of State Government, for the use of both the executive and legislative branches of the State Government in establishing a sound fiscal and administrative policy for the government of the State.

* * * It is also the desire of the Legislature to create the Office of the Auditor General, whose primary duties shall be to examine and report annually upon the financial statements prepared by the executive branch of the State and to perform such other related assignments as may be requested by the Legislature.

“Section 10501. The Joint Legislative Audit Committee is hereby created. The committee shall determine the policies of the Auditor General, ascertain facts, review reports and take action thereon, and make reports and recommendations to the Legislature and to the houses thereof concerning the state audit, the revenues and expenditures of the State, its departments, subdivisions, and agencies whether created by the Constitution or otherwise, and such other matters as may be provided for in the Joint Rules of the Senate and Assembly.”

The Price Waterhouse & Co. report contains the following comments on the duties of the Auditor General:

“As to the duties and functions of the office: the auditor should have the primary duty, and necessary authority, to examine and report annually upon the financial statements of the State; such statements should be required to be furnished to him by the Director of Finance, the State Controller and State Treasurer or other principal accounting offi-

cials. This should not require the annual examination of the statements and accounts of each department or agency; the scope of the work and the selection of the agencies should be left to the discretion of the auditor and his counseling committee. He should make such other examinations or investigations as he believes desirable and those he is directed to perform by the committee only, or the Legislature acting through it. * * *

"The auditor's authority, beyond that of examining, should be confined to reporting objectively and independently. The reports should include such comments, recommendations and suggestions as the auditor wishes to make but he should have no power to enforce them nor should he otherwise influence or direct executive or legislative actions. * * *

"The objectives of these examinations are given in the definition of the term 'auditing' which was set forth earlier in this section; restated briefly they are to ascertain:

"That the executive branch is carrying out only the activities and programs authorized by the Legislature and is doing so effectively and efficiently.

"That expenditures are made and revenues are collected in accordance with the laws and regulations.

"That the assets of the State are safeguarded and utilized properly.

"That the reports and financial statements prepared by the executive branch disclose all material information necessary to a proper evaluation of the State's activities."

We do not believe there is any basic difference between the duties of the position as outlined in the Price Waterhouse & Co. report and as contemplated by the law.

In a position at the level of Auditor General, which it must be remembered is the highest ranking auditing position in the State Government structure by a considerable margin, the duty to "examine and report annually upon the financial statements prepared by the executive branch of the State" Government necessarily, we believe, carries with it the responsibility to take all steps deemed necessary to satisfy himself as to the correctness of these statements from the standpoint of the objectives stated by Price Waterhouse & Co. This, as we see it, would involve not only a review of the procedures used by the internal auditors but might also involve, in selected instances, a review of their actual performance on the job as well as some examination of original records on its own responsibility.

C. Relationship to Department of Finance Audit

As previously indicated we believe the proper relationship between the Auditor General and the Department of Finance auditing is the same as would exist between independent auditors and top level internal auditors in a large corporation.

The last sentence in Section 10500 of the law reads as follows:

"The authority of the office, i.e. Auditor General, under the direction of the Joint Legislative Audit Committee is confined to examining and reporting and is in no way to interfere with adequate internal audit to be conducted by the executive branch of the government."

If this sentence is to have meaning, the term "confined to examining and reporting" which "is in no way to interfere with adequate internal audit to be conducted by the executive branch of the government," should probably be construed to mean that the Auditor General is expected to confine his audit primarily to a review of the adequacy and thoroughness of the executive internal audit as reflected in statements, controls, checks of working papers, and other procedures ordinarily followed by independent

auditors, and a reporting of the findings to the Legislature. It should probably be construed that the Legislature intended that duplication should be minimized to that required to ascertain the adequacy of the internal audit, and also that the office is to be entirely divorced from administrative responsibility as to the auditing necessary for the proper day-to-day operations of the State Government. To us it does not mean or imply that the Legislature necessarily accepts any existing concept of internal auditing as being proper, and does not preclude any finding that the existing pattern of internal auditing is either excessive or inadequate.

The interpretation of "adequacy" should probably be limited to the minimum ordinarily deemed to be necessary by certified public accountants. A review of the report prepared by the accounting firm of Price Waterhouse & Co. which was presented to committees of the Legislature in support of this bill, and which was the report used as a basis for preparing the bill, indicates the emphasis which is placed upon minimizing duplication of audit.

"The executive branch through its Department of Finance should be provided with internal accounting controls and procedures and collateral auditing staff sufficient to permit the Governor to report with confidence to the Legislature and the electorate. Such reports would be provided by the Director of Finance and his chief accounting officer who would be able to present the reports with the fullest confidence and without reliance on the work of officials or agencies not under the direction of the executive branch.

"The Legislature, either acting as a whole or through a special committee, should select and appoint an auditor to examine and report upon the financial statements submitted by the Governor and to undertake such special inquiries as the Legislature might direct."

Also, "The internal audit program is, of course, a part of internal accounting controls and would be reviewed by the auditor for the Legislature who would report on its adequacy."

The decision of Price Waterhouse & Co. to recommend that the bulk of auditing should be conducted as internal audit, and presumably the Legislature's acceptance of that position, varies from the concept in earlier bills which transferred the entire audit function from the executive to the Legislature. The principal concern of Price Waterhouse would appear to be that an audit should be made which is independent of the executive. Several alternative proposals for creating independent audits were suggested, but the study concluded that "* * * the principal auditing should be performed within the executive branch and reviewed by the proposed auditor for the Legislature." "The auditor should be an agent of the Legislature. * * *"

D. Relationship to Legislative Analyst

In the 1953 Session a bill establishing an Auditor General failed of passage, and members of the committee which heard the bill, among other things, commented upon the need to examine the relationship with the Legislative Analyst. Late in that session a concurrent resolution was introduced by Senator Hulse, Chairman of the Budget Committee, and adopted unanimously by the Legislature, authorizing a study of this entire problem by an independent firm of certified public accountants. The firm of

Price Waterhouse & Co., which made this study, gave careful consideration to the proper relationship between the proposed Auditor General and the Legislative Analyst and states in its report,

"It is our opinion that the area of activity proposed for the Auditor General requires training and talent differing in an important degree from that called for in the Legislative Analyst. The latter should be primarily a governmental financial consultant and analyst, an expert in administrative research. The Auditor General must be a trained public accountant-auditor fully familiar with accounting and auditing techniques. These attributes might conceivably be combined in one person; they could be combined in one office. However, the tasks in California are large enough and important enough to warrant their separation. Furthermore, the position of Auditor General is of importance sufficient to warrant an independent office with authority commensurate with its responsibilities. A position of lesser importance will not attract to it the caliber of personnel that it needs."

It further stated,

"The legislative committee with which the Auditor General would be associated should, it seems to us, consist of a relatively small number of members, say not more than six, of the Assembly and Senate, qualified to consider the general scope of the audit program and to evaluate the recommendations and suggestions that would be presented to it. The activities of the committee should, we believe, be confined to consideration of auditing, accounting and financial reporting. It should not as a committee function reach into areas of policy or budget, particularly those for which other committees may have been formed. However, it should not be precluded from review and comment on forms of organization, funds, or legislation having a direct bearing on accounting and financial reporting."

We would interpret this to mean that the Auditor General would be concerned with problems of efficiency and economy or adequacy or inadequacy in respect to the auditing and accounting functions of government and with the form of the statements which emanate therefrom. In these areas the Legislative Analyst should transpose audit findings of the Auditor General into budget recommendations affecting those various state agencies which are responsible for the audit, accounting, and financial control functions. In all other operations of state government, the Legislative Analyst should be responsible for budget and performance review and evaluation.

The Price Waterhouse study further points out that the primary task of the Legislative Analyst

"is to conduct a continuous research and fact-finding program on the State's operations with particular emphasis on the Governor's Budget, appropriation bills and reorganization proposals. It provides critical analyses of financial programs and proposed state services and furnishes comparative data relative to the programs in other states. Also, it serves the members of the Legislature and its committees as a research and reference organization."

We are in agreement with these statements. We believe that their emphasis upon an audit process which reviews the techniques and reporting statements of the executive by the Auditor General on the one hand, and a review of the executive performance as reflected in management and organization and legislative reference studied by the Legislative Analyst, on the other, serves as a good basis for distinguishing between the functions of these two officers.

E. Relationship to the State Controller

The Controller's Office is a state agency like any other state department and as such is subject to audit by the Department of Finance under Section 13294 of the Government Code. The Auditor General would, of course, have the same responsibility for reviewing the audit procedures used here as he would have with respect to any audits made by the Department of Finance.

The Controller's Office is one of the principal sources of financial statements covering the state operations, and as such, its activities would be of special interest to the Auditor General.

The Controller's Office also does some "post-auditing" of the expenditures by local governments of state subventions or loans and we believe it would be an appropriate part of the Auditor General's responsibility to review the procedures used.

APPENDIX B

OFFICE OF THE AUDITOR GENERAL ROSTER OF EMPLOYEES

Auditor General—William H. Merrifield *

Deputy Auditor General—John W. Shoemaker *

Audit staff (by years of recruitment):

1956:

Richard S. Brown *
Bruce C. Elliott *
John E. Finnstrom *
Daniel J. French
Quintus C. Fuller * — separated
December 31, 1958
Wesley A. Lueth *
Charles C. Marks *
Richard F. Neu * — separated
September 24, 1958
George A. Olson * — separated
September 3, 1957
Paul J. Petersen *
Eugene V. Pongratz
Walter J. Quinn *
Doyle B. Saxby *
Fred F. Schow *
Jack A. Schwartz *
Russell K. Shattuck
George B. Stiles †
Samuel S. Yngve * — separated
September 3, 1958

1957:

LeRoy I. Harris *
Timothy L. Hayes
Robert W. Hornbeck *
H. Bruce Joplin *

1957—Continued

Loren C. Krumwiede * —
separated March 12, 1958
Leonard T. Metz — separated
December 5, 1958
Albert L. Monighan *
Wesley E. Voss *

1958:

Arthur R. Barnes
Donald Ellis
Robert H. Garrett
Foster Maxwell
Bill J. Williams
Richard J. Wirth
Jay L. Wright, Jr.
James B. Young

Office staff:

1956:

Gloria W. Bitterling
Helen Carver — separated
September 4, 1958

1957:

Constance M. Malloy
Stella S. Hill — separated
July 31, 1958

1958:

Arlene Morris

* Those employees having an asterisk (*) after their names are Certified Public Accountants.

† Mr. Stiles has written the examination for Certified Public Accountant successfully but the issuance of a certificate has been deferred until experience requirements have been fulfilled.

APPENDIX C

OFFICE OF THE AUDITOR GENERAL
SUMMARY OF DIRECT TIME IN HOURS REPORTED ON ASSIGNMENTS
CLASSIFIED BY FUNCTIONS OF STATE GOVERNMENT
TO DECEMBER 31, 1958

<i>Function</i>	<i>1956</i>	<i>1957</i>	<i>1958</i>
Legislative—includes special work for committees.....	38	1,017	2,072
Judicial	—	64	—
Executive	—	35	—
General Administration	—	1,371	3,547
Agriculture	200	992	1,280
Corrections	404	2,569	3,056
Youth Authority	98	774	1,932
Education	369	3,075	4,957
Employment	144	732	—
Fiscal Affairs:			
Board of Control.....	8	—	—
State Controller	1,783	4,075	1,749
Board of Equalization.....	—	1,116	42
Department of Finance.....	114	2,779	3,626
Franchise Tax Board.....	—	549	2,020
State Treasurer	15	1,692	849
Highway Patrol	—	300	126
Industrial Relations.....	—	306	25
Justice	—	315	125
Mental Hygiene	406	1,810	1,469
Military Affairs	—	186	—
Motor Vehicles	—	1,624	3,140
Natural Resources	132	2,323	3,089
Public Health	131	130	—
Public Works	372	3,075	9,177
Regulation and Licensing	88	3,517	2,596
Social Welfare	152	140	1,144
Veterans Affairs	176	257	718
Water Resources	48	238	1,649
Miscellaneous:			
Capital Outlay and Savings Fund.....	—	108	
Subventions	—	942	566
Compensation Insurance Fund.....	—	628	19
San Francisco Port Authority.....	—	207	98
Internal Control—general	—	—	233
Olympic Commission	—	—	383
Total	<u>4,678</u>	<u>36,838</u>	<u>49,795</u>

APPENDIX D
OFFICE OF THE AUDITOR GENERAL
REPORTS PREPARED TO DECEMBER 31, 1958

Legislative

Report on Study of Claim Processing Procedures in Office of State Controller and in Selected State Agencies. Prepared for the Senate Finance Committee (February 20, 1957) 33 pp., 2 appendixes.

Accounting Records and Procedures for the Assembly of the State of California (in two parts). Prepared for the Assembly Rules Committee (February 4, 1958) Part I—41 pp.; Part II—25 statements.

Financial Statements for San Francisco Bay Area Facilities as of June 30, 1957. Prepared for the Senate Interim Committee on Bay Area Problems (September 5, 1958) 33 statements.

Division of Beaches and Parks of the Department of Natural Resources, Property Acquisitions for the Period From July 1, 1945, to June 30, 1958. Prepared for the Beaches and Parks Subcommittee of the Assembly Committee on Conservation, Planning, and Public Works. (November 20, 1958) 9 pp. 6 statements.

General Administration

Report on Review of the System of Internal Control, Secretary of State (February 25, 1958) 5 pp.

Agriculture

Report on Review of the System of Internal Control, Department of Agriculture (February 7, 1958) 10 pp.

Corrections

Report on Review of the System of Internal Control in the Correctional Industries Revolving Fund (December 4, 1957) 12 pp.

Report on Review of the System of Internal Control, Department of Corrections (April 18, 1958) 12 pp.

Youth Authority

Report on Review of the System of Internal Control, Department of Youth Authority (February 25, 1958) 9 pp.

Education

Report on Review of the System of Internal Control in the Division of Departmental Administration (August 13, 1958) 7 pp.

Report on Review of the System of Internal Control in the Division of State Colleges and Teacher Education (August 8, 1958) 18 pp.

Report on Review of the System of Internal Control in the Division of Special Schools and Services (August 11, 1958) 16 pp.

Report on Examination of Sacramento State College, Year Ended June 30, 1957 (December 18, 1958) 9 pp., 5 statements.

Board of Equalization

Report on Review of the System of Internal Control, State Board of Equalization (December 2, 1957) 22 pp.

Department of Finance

Report on Review of the System of Internal Control in the State Lands Division of the Department of Finance (March 7, 1958) 7 pp.

Report on Review of the System of Internal Control in the Administrative Division of the Department of Finance (March 11, 1958) 12 pp.

Report on Examination of State Printing Fund, Year Ended June 30, 1957 (April 3, 1958) 31 pp., 3 statements, 1 appendix.

Report on Examination of Purchasing Revolving Fund, Year Ended June 30, 1957 (September 24, 1958) 14 pp., 6 statements.

Franchise Tax Board

Report on Review of the System of Internal Control in the Franchise Tax Board (January 27, 1958) 14 pp.

State Treasurer

Report on Review of the System of Internal Control, Office of the State Treasurer (June 5, 1958) 16 pp.

Report on Examination of Surplus Money Investment Fund, Year Ended June 30, 1957 (June 5, 1958) 9 pp., 4 statements.

Highway Patrol

Report on Review of the System of Internal Control, Department of California Highway Patrol (January 15, 1958) 8 pp.

Industrial Relations

Report on Review of System of Internal Control, Department of Industrial Relations (January 17, 1958) 9 pp.

Report on Review of System of Internal Control, State Compensation Insurance Fund (January 8, 1958) 11 pp.

Justice

Report on Review of the System of Internal Control, Department of Justice (December 6, 1957) 10 pp.

Mental Hygiene

Report on Review of the System of Internal Control, Department of Mental Hygiene (December 3, 1957) 47 pp., 1 statement.

Supplementary Report on Review of System of Internal Control, Department of Mental Hygiene (February 13, 1958) 18 pp.

Motor Vehicles

Report on Review of the System of Internal Control, Department of Motor Vehicles (January 15, 1958) 6 pp.

Natural Resources

Report on Review of the System of Internal Control, Department of Natural Resources (December 10, 1957) 9 pp.

Report on Review of the System of Internal Control, Department of Fish and Game (December 3, 1957) 11 pp.

Report on Examination of the California Olympic Commission, Period from September 7, 1955, through June 30, 1958 (November 12, 1958) 12 pp., 2 statements, 2 appendixes.

Public Works

Report on Examination of Architecture Revolving Fund, Year Ended June 30, 1957 (December 12, 1958) 53 pp., 6 statements, 1 appendix.

Report on Review of System of Internal Control in the Division of Highways (February 12, 1958) 19 pp., 12 appendixes.

Regulation and Licensing

Report on Review of the System of Internal Control, Public Utilities Commission (January 3, 1958) 9 pp.

Report on Examination of State Banking Fund, Year Ended June 30, 1957 (June 9, 1958) 8 pp., 3 statements.

Report on Examination of Insurance Fund, Year Ended June 30, 1957 (June 10, 1958) 12 pp., 3 statements.

Report on Examination of Real Estate Fund, Year Ended June 30, 1957 (August 15, 1958) 11 pp., 4 statements.

Report on Examination of Real Estate Education and Research Fund, July 3, 1956, through June 30, 1957 (August 18, 1958) 2 pp., 2 statements.

Report on Examination of Savings and Loan Inspection Fund, Year Ended June 30, 1957 (February 17, 1958) 11 pp., 3 statements.

Report on Examination of Board of Pilot Commissioners' Special Fund, Year Ended June 30, 1957 (September 19, 1958) 6 pp., 3 statements.

Report on Review of the System of Internal Control, Department of Professional and Vocational Standards (February 20, 1958) 12 pp.

Reports on examinations of funds of the Department of Professional and Vocational Standards for the year ended June 30, 1957:

Professional and Vocational Standards Fund (August 14, 1958) 11 pp., 6 statements.

Accountancy Fund (August 4, 1958) 7 pp., 4 statements.

Architectural Examiners Fund (June 18, 1958) 6 pp., 3 statements.

Athletic Commission Fund (September 10, 1958) 7 pp., 3 statements.

Barber Examiners' Fund (July 31, 1958) 7 pp., 3 statements.

Cemetery Fund (June 19, 1958) 6 pp., 3 statements.

State Board of Chiropractic Examiners' Fund (July 21, 1958) 7 pp., 3 statements.

Professional Engineer's Fund (July 31, 1958) 7 pp., 3 statements.

Contractors License Fund (June 11, 1958) 8 pp., 4 statements.

Board of Cosmetology's Contingent Fund (June 17, 1958) 8 pp., 3 statements.

State Dentistry Fund (June 30, 1958) 7 pp., 3 statements.

Dry Cleaners' Fund (July 30, 1958) 8 pp., 4 statements.

Funeral Directors and Embalmers Fund (July 29, 1958) 7 pp., 3 statements.

Bureau of Furniture and Bedding Inspection Fund (September 18, 1958) 8 pp., 3 statements.

Board of Landscape Architects Fund (June 16, 1958) 6 pp., 3 statements.

Contingent Fund of the Board of Medical Examiners (October 8, 1958) 10 pp., 3 statements.

Physical Therapy Fund (June 19, 1958) 6 pp., 3 statements.

Board of Nurse Examiners Fund (June 19, 1958) 8 pp., 3 statements.

State Optometry Fund (June 27, 1958) 6 pp., 3 statements.

Pharmacy Board Contingent Fund (July 8, 1958) 7 pp., 3 statements.

Private Investigators and Adjusters Fund (June 18, 1958) 7 pp., 4 statements.

Shorthand Reporters Fund (June 16, 1958) 7 pp., 3 statements.

Registered Social Workers' Fund (June 20, 1958) 6 pp., 3 statements.

Structural Pest Control Fund (April 7, 1958) 6 pp., 3 statements.

Veterinary Medicine Contingent Fund (July 29, 1958) 7 pp., 3 statements.

Vocational Nurse Examiners Fund (June 19, 1958) 7 pp., 3 statements.

Yacht and Ship Brokers Fund (July 10, 1958) 6 pp., 3 statements.

Report on Examination of Division of Administrative Procedure of the Department of Professional and Vocational Standards, Year Ended June 30, 1957 (October 15, 1958) 6 pp., 4 statements.

Veterans Affairs

Report on Review of the System of Internal Control, Department of Veterans Affairs (February 19, 1958) 8 pp.

Water Resources

Report on Special Investigation of the Accounting Procedures and Records of the Department of Water Resources for the Year Ended June 30, 1958 (August 20, 1958) 71 pp.

Miscellaneous

Report on Review of the System of Internal Control, San Francisco Port Authority (May 6, 1958) 11 pp.

APPENDIX E

OFFICE OF THE AUDITOR GENERAL REPORTS IN PROCESS AT DECEMBER 31, 1958

General Administration

Report on Examination of State Employees' Retirement Fund, Year Ended June 30, 1957.
Report on Examination of State Employees' Retirement System, General Fund, Year Ended June 30, 1957.
Report on Examination of Old Age and Survivors' Insurance Revolving Fund, Year Ended June 30, 1957.
Report on Examination of Legislators' Retirement Fund, Year Ended June 30, 1957.

Agriculture

Report on Examination of the Department of Agriculture, Year Ended June 30, 1958.

Corrections

Report on Examination of Correctional Industries Revolving Fund, Year Ended December 31, 1957.

Education

Report on Examination of Chico State College, Year Ended June 30, 1958.
Report on Examination of Fresno State College, Year Ended June 30, 1958.
Report on Examination of San Francisco State College, Year Ended June 30, 1958.
Report on Examination of San Jose State College, Year Ended June 30, 1958.
Report on Examination of Oakland Orientation Center for the Adult Blind, Year Ended June 30, 1958.
Report on Examination of California Industries for the Blind, Manufacturing Fund, Year Ended June 30, 1958.
Report on Examination of California Industries for the Blind, General Fund, Year Ended June 30, 1958.
Report on Examination of Surplus Educational Property Revolving Fund, Year Ended June 30, 1958.
Report on Examination of State School Fund, Year Ended June 30, 1958.

State Controller

Report on Examination of Special Deposit Fund, Year Ended June 30, 1958.
Report on Review of Auditing of Local Subvention Program.
Report on Examination of Unclaimed Property Fund, Year Ended June 30, 1957.

Department of Finance

Report on Examination of State Fair Fund, Year Ended June 30, 1958.
Report on Examination of the State Lands Act Fund, Year Ended June 30, 1958.
Report on Examination of the Sixth District Agricultural Association Fund, Year Ended June 30, 1958.
Report on Examination of Fairs and Exposition Fund, Year Ended June 30, 1958.
Report on Examination of Investment Fund, Year Ended June 30, 1958.

Highway Patrol

Report on Examination of Motor Vehicle Fund, Year Ended June 30, 1957.

Mental Hygiene

Report on Examination of Stockton State Hospital, Year Ended June 30, 1958.

Motor Vehicles

Report on Examination of Motor Vehicle Fund, Year Ended June 30, 1957.

Report on Examination of Motor Vehicle License Fee Fund, Year Ended June 30, 1957.

Natural Resources

Report on Examination of State Park Maintenance Fund, Year Ended June 30, 1957.

Report on Examination of State Park Fund, Year Ended June 30, 1957.

Report on Examination of State Park Contingent Fund, Year Ended June 30, 1957.

Report on Examination of State Beach Fund, Year Ended June 30, 1957.

Report on Examination of the Division of Soil Conservation, Year Ended June 30, 1957.

Report on Examination of Petroleum and Gas Fund, Year Ended June 30, 1957.

Report on Examination of the Division of Mines, Year Ended June 30, 1957.

Report on Examination of the Water Pollution Control Board, Year Ended June 30, 1957.

Report on Examination of Administrative Services, Department of Natural Resources, Year Ended June 30, 1957.

Report on Examination of State Water Pollution Control Fund, Year Ended June 30, 1957.

Report on Examination of Soil Conservation Development Fund, Year Ended June 30, 1957.

Public Works

Report on Examination of Architecture Public Building Fund, Year Ended June 30, 1957.

Report on Examination of Architecture General Fund, Year Ended June 30, 1957.

Report on Examination of California Toll Bridge Authority, Year Ended June 30, 1958.

Social Welfare

Report on Examination of the Department of Social Welfare, Year Ended June 30, 1958.

Report on Examination of Citizen's Advisory Committee on Aging, Year Ended June 30, 1958.

Veterans Affairs

Report on Examination of the Department of Veterans Affairs, Year Ended June 30, 1958.

APPENDIX F

OFFICE OF THE AUDITOR GENERAL
AUDIT ASSIGNMENTS IN PROCESS AT DECEMBER 31, 1958

General Administration

Audit of the Office of the Secretary of State, Year Ended June 30, 1958.

Corrections

Audit of the State Prison at Soledad, Year Ended June 30, 1958.

Youth Authority

Audits for Year Ended June 30, 1958:

Departmental Headquarters;
Fricot Ranch School for Boys;
Preston School of Industry;
Ventura School for Girls.

Education

Audit of the Department of Education Headquarters, Year Ended June 30, 1958.

State Controller

Review of Annual Report of State Controller for the Year Ended June 30, 1958.

Franchise Tax Board

Audit of the Franchise Tax Board, Year Ended June 30, 1958.

Mental Hygiene

Audit of Metropolitan State Hospital, Year Ended June 30, 1958.

Natural Resources

Audit of the Department of Fish and Game, Year Ended June 30, 1958.

Public Works

Audit of District III of the Division of Highways, Year Ended June 30, 1958.

Audit of District X of the Division of Highways, Year Ended June 30, 1958.

Review of Financial Statements of the Division of Highways, Year Ended June 30, 1958.

Regulation and Licensing

Audit of Public Utilities Commission for the Year Ended June 30, 1958.

Miscellaneous

Special Study of Capital Outlay and Savings Fund.

APPENDIX G

DEFALCATIONS IN STATE AGENCIES

During 1958 several defalcations have been disclosed. When defalcations occur, an agency is supposed to notify the Department of Finance and the Audits Division makes an audit to disclose the extent of the loss. The Audits Division has advised the Auditor General of all of these irregularities except one which was disclosed during an audit by the Auditor General. A summary of each of these irregularities follows:

Department of Mental Hygiene

The deportation officer, a staff supervisor at Sacramento, embezzled \$1,961.07 of unrecorded receipts. This embezzlement was disclosed by a Department of Finance auditor who had been informed by the Auditor General that checks and cash received from deported patients' relatives were turned over to the deportation officer without first being recorded.

The entire amount of this loss has been recovered, and the employee who was near retirement age retired.

To prevent future irregularities of this type, the system of internal control has been improved by changes in procedures suggested by the Audits Division of the Department of Finance.

Department of Fish and Game

A license clerk in the Fresno office embezzled \$1,015.95 of license fees. This embezzlement was disclosed by employees of the Department of Fish and Game as a result of a recommendation by the Auditor General that led to the separation of cash handling and recordkeeping duties.

The State has recovered \$488.34 of this loss from salary and retirement contributions which have been signed over to the State. A claim is to be made against the bonding company for the balance.

The employee was dismissed immediately, and a felony complaint has been filed with the District Attorney at Fresno.

The system of internal control has been improved by a separation of duties which will materially aid in the prevention of similar irregularities.

Department of Education

At San Jose State College inadequate control over blank checks resulted in a loss of \$1,894.18. This loss occurred nine months after the Auditor General had informed the business manager and accounting officer of the college that the supply of unused checks was not being adequately safeguarded to prevent misuse by unauthorized personnel.

The entire amount of the loss was recovered through the State Treasurer's forgery bond.

The former employee served a 60-day sentence in Baltimore for passing some of the checks, and the department has advised that he is now in a California state prison.

Blank checks are now kept in a locked cabinet at San Jose State College, and all college business offices have been notified by the department of the importance of preventing unauthorized access to blank checks. Section 7641 of the State Administrative Manual directs all agencies to keep check stock under strict control at all times. The college failed to observe this rule. The Audits Division of the Department of Finance calls the attention of the agencies to this rule when they note failure to observe it.

At San Francisco State College unsound accounting practices resulted in an embezzlement of \$9,923.44 of extension division cash receipts. This embezzlement took place over several years and was not disclosed until an employee relieved the regular extension division cashier during her absence in August, 1955. The college business manager did not report the embezzlement to the Department of Finance until June, 1957. The extension division cashier received two promotions and salary increases after the irregularities were disclosed and continued employment at the college until she resigned on May 7, 1958. The committee was highly critical of the college officials responsible for the failure to report this embezzlement and for the promotions and salary increases in this case which, the committee felt, were a gross abuse of the "merit system."

The following deficiencies in internal control existed during the period in which the embezzlement occurred:

- (1) Prenumbered cash receipt forms were not used and accounted for where necessary.
- (2) Cash receipts were not deposited promptly and intact.
- (3) Refunds were made out of undeposited collections.
- (4) Cash receipts were not reconciled with registration statistics to verify that the State received all of the fees that it should have received.

The amount of \$5,000 has been recovered on the faithful performance bond of the former employee. Vacation pay in the amount of \$656.58 has been withheld.

The employee pleaded guilty to a charge of embezzlement and admitted taking \$1,300. The employee was fined \$250, placed on probation for five years, and directed to make such restitution as shall be determined by the probation authorities.

Fee collection procedures have been changed at the San Francisco State College to improve internal control. The Department of Education reports that the other colleges have reviewed their off-campus procedures and made improvements recommended by the Department or by the Audits Division of the Department of Finance. In addition, a survey of state colleges' registration collection procedures was initiated by the Organization and Cost Control Division of the Department of Finance in September, 1958.

Department of Corrections

At San Quentin State Prison internal control deficiencies in the processing of Correctional Industries inmate payrolls resulted in the following defalcations:

- (1) Inmate clerks added names of other inmates to the payrolls after the payrolls had been approved.

(2) An inmate payroll clerk and other inmates were paid in excess of the authorized amounts.

Since inmates receive a nominal wage the amount of the loss was only \$115.20. The department reports that this amount has been recovered.

Disciplinary action was taken against all of the inmates involved. The civil service employee responsible for the preparation of the inmate payroll has been issued an official reprimand and has been placed under closer supervision of the industries general accountant.

The central office staff is continuing to study control procedures with a view toward making improvements at all of the institutions.

First District Agricultural Association

Cash received from the sale of admission tickets and other sources during 1957 and 1958 in the amount of \$2,625.63 was not deposited in the association's bank account. This shortage was discovered by the Department of Finance auditors during their recent examination covering the period from July 1, 1955, to May 31, 1958. The following conclusions were made in a letter prepared by the Audits Division:

"It is apparent that these shortages occurred because prescribed accounting records were not maintained, internal controls were not established and work of the employees was not adequately supervised. We conclude that:

- "1. The secretary-manager is responsible for the unexplained shortage of \$443.50 in ticket collections. (May, 1957)
- "2. The secretary to the secretary-manager is responsible for \$1,242.63 in other missing 1957 collections. The records show that she issued receipts for this amount of money but she has nothing in writing to show that she turned the money over to someone else. At the very least she was negligent for transferring coin and currency without obtaining receipts to establish accountability.
- "3. In addition to the \$782 taken for which she has made restitution, a book-keeper is responsible for the difference between what she paid back and the total shortage in 1958 collections, or \$157.50."

The employee who admitted taking \$782 made restitution of that amount and was dismissed. The State Attorney General has been requested to investigate the shortages and advise the board of directors of the association as to any further action to be taken.

An accountant has been employed by the association on a part-time basis to advise management in setting up proper internal control procedures.

o